No. 15340.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ELGIN R. PARKER and FLO PARKER,

Appellants,

vs.

HARRY C. WESTOVER, individually and as Former Collector of Internal Revenue for the Sixth District of California,

Appellee.

ELGIN R. PARKER and FLO PARKER,

Appellants,

vs.

R. A. RIDDELL, District Director of Internal Revenue, Los Angeles, California,

Appellee.

On Appeal From the Judgments of the United States District Court for the Southern District of California.

BRIEF FOR THE APPELLEES.

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FILED
MAY - 8 1957
PAUL P. O'BRIEN, CLERK

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BRIEF FOR THE APPELLEES.

Opinions Below.

The findings of fact, conclusions of law, and opinion of the District Court [R. 31-33, 47-56] are reported at 144 F. Supp. 933. A supplemental opinion [R. 33-34] is not officially reported.

Jurisdiction.

These consolidated appeals involve deficiencies in federal income taxes for the calendar years 1945, 1946, 1947 and 1948, in the aggregate amount of $282,164.96. [R. 48, 194.] Timely claims for refund were filed and, within

the time provided in Section 3772 of the Internal Revenue Code of 1939, taxpayers filed suits for recovery of the taxes paid. [R. 48.][1] Jurisdiction was conferred on the District Court by 28 U. S. C., Section 1340.

The judgment of the District Court was entered on July 12, 1956, and taxpayers filed a notice of appeal on August 13, 1956. [R. 56-57.] The jurisdiction of this Court is invoked under the provisions of 28 U. S. C., Section 1291.

Question Presented.

Whether the District Court erred in concluding, upon all of the evidence, that the taxpayers did not intend, in good faith and acting with a business purpose, to enter into partnership, during the years 1945 through 1948, with the guardianship estates established for their minor children.

Statutes and Regulations Involved.

The Statutes and Regulations involved are set forth in the Appendix, *infra*.

Statement.

The findings of fact [R. 48-55] of the District Court may be summarized as follows:

Beginning in November, 1942, and until October 31, 1943, taxpayers Elgin R. Parker and Flo Parker, who are husband and wife, operated, as a partnership, a busi-

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[1]The deficiencies asserted against taxpayer Elgin R. Parker for the years 1945 and 1946 were paid, abated or satisfied by credits in installments and on the dates shown in Exhibit A, attached to the answer to his complaint. [R. 20, 24-25, 28-29.] Details with respect to payments made by both taxpayers for the years 1947 and 1948 are set forth at R. 173-176.

ness known as Southern Heater Company, which consisted of the manufacturing and selling of gas water heaters.[2] Each taxpayer owned a one-half interest in the partnership. [R. 49.]

On October 31, 1943, taxpayers, by written deeds of gift, each gave to each of their then four minor children an undivided one-eighth interest in the partnership then conducted by them. [R. 49.][3]

On November 1, 1943, Elgin R. Parker petitioned the Superior Court of Orange County, California, wherein the taxpayers were then residing, for an appointment of himself as guardian of the assets of his four children, which had been transferred to these children by the deeds of gift. This petition was granted and an order appointing the father as guardian of his children was made by the Superior Court on December 31, 1943. After his appointment as guardian, Elgin R. Parker, with the consent of the Superior Court, entered into a general partnership agreement between himself as guardian of his four children, himself as an individual, and his wife, Flo Parker, for the purpose of carrying on the business of the Southern Heater Company. This general partnership agreement was effective November 1, 1943, the day after the deeds of gift to the children. The business of the Southern Heater Company was continued after November 1, 1943, in the same place with the same capital under the same management of Elgin R. Parker. [R. 50.]

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[2]Prior thereto, taxpayer Elgin R. Parker had been engaged in the business as sole proprietor. [R. 49, 92.]

[3]A fifth child born in 1945 is not involved in these proceedings. [R. 49.]

Starting with little capital, taxpayer Elgin R. Parker had increased the income of the Southern Heater Company from the date of its inception in the late nineteen thirties until October 31, 1943, so that for the fiscal year ended October 31, 1943, the Southern Heater Company showed a net profit of $193,000. Subsequent to the formation of the partnership on November 1, 1943, the net income of the Southern Heater Company was as follows: Fiscal year ended October 31, 1944, $263,928.92; fiscal year ended October 31, 1945, $229,646.15; fiscal year ended October 31, 1946, $307,983.48; fiscal year ended October 31, 1947, $26,696.66; fiscal year ended October 31, 1948, $57,629.12. [R. 49, 50.]

Despite the large partnership earnings and profits during the years in question the only disbursement to the guardianship estate out of the business profits was a disbursement of $3,750 in United States war bonds to each of the four children during the year 1945. At the termination of the partnership on October 31, 1948, the only assets which the children had in their guardianship estates were stocks in various corporations, and notes given by the taxpayers for monies borrowed by the parents from the guardianships. The corporations had been formed in 1946 and succeeding years to take over certain partnership assets and operations in exchange for their stock which the partnership held. [R. 51.]

The Commissioner of Internal Revenue determined that all income earned by the Southern Heater Company during the fiscal years ended October 31, 1944, through October 31, 1948, was taxable to the parents and that the partnership arrangement was merely a reallocation of income within the family group. At the same time the Com-

missioner determined that there had been overassessments of the taxes paid by the guardianship estates for the calendar years 1944 through 1948. With the approval of the Superior Court, taxpayers borrowed the refunds due the children and applied them toward additional taxes resulting from the Commissioner's determination. Notes were issued for the sums borrowed. [R. 53.]

Although Elgin R. Parker, as guardian of the children's estates, filed annual reports with the Superior Court, he exercised sole control in the operation of the Southern Heater Company and subsidiary corporations. Whereas he ostensibly represented the children as their guardian, he did not operate the business after November 1, 1943, in any manner different from the way it had been operated prior thereto. Permission of the Superior Court was neither sought nor obtained for the operation of the business. At no time was any act of Elgin R. Parker as guardian in the guardianship proceedings opposed by any party nor was any petition or request by him to the Superior Court denied. [R. 51, 52.] Furthermore, neither the children nor Flo Parker contributed any services to the partnership at any time, nor did they participate in the management or control thereof. [R. 51.]

All the capital used in the operation of the business of the Southern Heater Company came from the operations and profits of the company. None originated from sources outside the business. Neither Flo Parker nor the children contributed any capital toward the operation of the business. The amount of capital in the business was not changed in any way because of the creation of the guardianships or because of the deeds of gift to the children on October 31, 1943. [R. 52.]

During the fiscal years ended October 31, 1945, 1946, 1947 and 1948, the income of the Southern Heater Company was produced entirely as the result of the personal services of Elgin R. Parker and of the capital which the company had at the commencement of the partnership and which was additionally accumulated from retained earnings. Capital was not a material income-producing factor of the company during the years involved. [R. 53-54.]

Taxpayers had no business purpose in making the deeds of gift to their children or in the creation of the general partnership. Their sole expressed purpose was to help the children and to provide an inducement for the children to enter the business of the family. This expressed purpose was not credible and lacked foundation when considered in light of the fact that taxpayers created a general partnership which rendered the entire interest of the children subject to the claims of creditors and in the light of the tender ages of the children during the partnership period. Moreover, none of the children has actively entered into the business or even expressed a determination to enter the business. [R. 52.] At the time the gifts were made, taxpayer's four children were fourteen, eleven, six and three years old. [R. 49.]

The creation of the general partnership following the deeds of gift to the children of an interest in the going business affected the titular ownership of the business and the legal form but not the economic substance thereof. The additional partners after October 31, 1943, had no business effect whatsoever on the operation of the Southern

Heater Company. [R. 53.] Neither did the partnership effect any real change in the economic or financial status of the Parker family. All the income from the partnership business allocated to the guardianship estates for the Parker children was earned by Elgin R. Parker and merely amounted, as the Commissioner determined, to a reallocation of income within the family group. [R. 53, 54.]

The District Court found as an ultimate fact that, considering all the facts—the deeds of gift, the partnership agreement, the conduct of the parties, the execution of the provisions of these gifts and agreement, statements and testimony of the witnesses, the relationship of the parties, their respective abilities and capital contribution, the actual control of the income allocated to the guardianship estates and all other facts throwing light on their true intent—the parties did not in good faith and acting with a business purpose intend that the guardianship estates should join together with the taxpayers herein in the present conduct of the partnership enterprise known as the Southern Heater Company. [R. 54-55.]

Accordingly, it concluded that taxpayers failed to sustain their burden of proving that, in good faith and acting with a business purpose, they intended that their children or Elgin R. Parker, as guardian of the children's estates, join together with them as partners in the conduct of the Southern Heater Company; that they were not partners in the operation of the business; that none of the income from the business should be attributed to Parker as guardian of the children's estates or to the children them-

selves; and that taxpayers did not overpay their federal income taxes for the years 1945, 1946, 1947 and 1948. [R. 55-56.]

Upon the basis of its findings and conclusions, the District Court entered judgment dismissing the complaint. [R. 56-57.]

Summary of Argument.

These cases involve an attempt to avoid federal income taxes by reallocating income among an intimate family group through the instrumentality of an alleged partnership. The question is whether, considering all the facts, the parties, in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise. Under controlling law and the facts of record, this question must be answered in the negative, as the District Court found. While no single factor is conclusive, absence of a contribution of original capital by the alleged partners, or of vital services, or of participation in management and control, such as exists here, places a heavy burden on the taxpayers to show that their children were true owners of a partnership interest.

During the alleged partnership years, the children were minors and performed no vital services in connection with the operation of the business. A hope that they might perform such services at some future date is not a basis for the present taxation of income to them.

Neither did the children, through the guardianship estates, contribute any new capital to the business. Their alleged capital contribution consisted of gifts of an interest in a going concern previously owned and operated by their parents. At most, the alleged partners received bare legal title to a part of the business assets, but this

alone is insufficient to render them partners for tax purposes. Nor does the retention of accumulated earnings in the business effect any different result where under all the facts it is clear that they were not the true owners of the gift capital.

The facts also show that the children did not participate in the management or control of the business. As he admitted, their father, taxpayer Elgin R. Parker, continued to run the business as he had prior to the formation of the alleged new partnership. He made all the decisions and neither sought nor obtained the advice or consent of the court having jurisdiction over the guardianship estates with respect to the operation of the business.

Furthermore, the parties did not act with a business purpose. Rather, the sole purpose of taxpayers in entering into the alleged partnership arrangement was to obtain a tax benefit at the expense of the United States. This is apparent from the testimony that Mr. Parker was aware of tax advantages in making the gifts, that it was expected and intended that the children would pay a tax on their share of the income, that if he had realized that it would be held otherwise he would have immediately liquidated the business, and from the fact that taxpayers sought and obtained permission of the probate court to satisfy their tax deficiencies with money from the children's accounts.

Under the facts, then, the District Court had no alternative but to conclude that the parties did not, in good faith and acting with a business purpose, intend to join together as partners in the present conduct of a business enterprise.

ARGUMENT.

THE DISTRICT COURT CORRECTLY DECIDED THAT THE GUARDIANSHIP ESTATES ESTABLISHED FOR THE BENEFIT OF TAXPAYERS' MINOR CHILDREN WERE NOT PARTNERS FOR TAX PURPOSES IN THE OPERATION OF THE BUSINESS OF THE SOUTHERN HEATER CAMPANY.

A. Preliminary Statement.

The prior history of these cases is to be found in the opinion of this Court in *Parker v. Westover,* 221 F. 2d 603. It shows that, by deficiency notices issued in 1947 with respect to the income tax year 1944, the Commissioner of Internal Revenue took the position that the Parker children were not valid partners for tax purposes. Taxpayers paid the deficiencies, filed claims for refund, and brought suit for recovery. A jury trial was had in 1950 which resulted in judgment for the Collector, thereby sustaining the Commissioner's position. In a *per curiam* opinion, this Court affirmed the judgment. *Parker v. Westover,* 186 F. 2d 49.

Subsequently, in 1951, the taxpayers each filed complaints to recover amounts of deficiencies which they had paid with respect to the taxable years 1945 and 1946, pursuant to deficiency notices issued in 1949. The same ground was alleged as for the 1944 deficiency. The District Court dismissed the complaints on the ground of *res judicata.* Upon appeal, this Court reversed, stating two reasons for its conclusion that the rule of collateral estoppel was improperly applied by the District Court.

The first reason related to the fact that subsequent to the jury trial in 1950 an agreement was reached with the Orange County Superior Court as to the parents' claim against the guardianship funds. [R. 103, 104, 156-159.] As stated by this Court (221 F. 2d 603, 606), under this

plan, if the parents won the 1944 tax litigation, they would return to the guardianship estates the amount of the children's income tax refunds which they had borrowed, plus interest; if they lost, they would receive from the guardianship estates amounts necessary to apportion taxes among the partners proportionate to their employment of partnership income.[4] This Court considered that this agreement represented the settlement of an evidentiary fact question which had been in dispute before the jury in the litigation pertaining to the tax year 1944; that in a trial covering the years 1945 and 1946 "both the taxpayer and the Government will be in a position to argue to a jury the effect of this new evidentiary fact upon the original partnership agreement"; and that because this introduced the possibility of a different verdict, the bar of collateral estoppel was lifted.

Secondly, this Court concluded that the rule of collateral estoppel was not applicable because the District Court had failed to consider (in connection with a claim of change in controlling legal principles) the impact on the case of the amendment of the family partnership provisions of the Internal Revenue Code of 1939 effected by Section 340(a) and (b) of the Revenue Act of 1951, c. 521, 65 Stat. 452, and the committee reports pertaining thereto.

On remand, the cases involving the taxable years 1945 and 1946 were later consolidated with the cases filed by each taxpayer on September 15, 1955, covering the taxable years 1947 and 1948. All four cases were then tried by the court below without a jury, whereupon judgment was entered in favor of the Government. [R. 47-48, 56-57, 194.]

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[4]The plan also extended to the litigation involving the years 1945 and 1946. [R. 148-152.]

B. The Record Amply Supports the District Court's Findings and Conclusions.

The sole question presented is whether, for federal income tax purposes, taxpayer Elgin R. Parker as guardian for the estates of his four minor children was a partner in the operation of the business known as the Southern Heater Company or whether the children individually were such partners. The question is one of fact and depends upon the intent of the parties. *Commissioner v. Culbertson,* 337 U. S. 733, 742-743; *Toor v. Westover,* 200 F. 2d 713, 714 (C. A. 9th). The test determinative of that intent is "whether, considering all the facts * * * the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Commissioner v. Culbertson, supra,* p. 742. Applying this test, the court below found that they did not [R. 54-55], and the facts of record fully support that finding. Unless this factual conclusion is "clearly erroneous," it may not be disturbed on appeal. *Smith v. Westover,* 237 F. 2d 201, 203 (C. A. 9th). Whether the evidence would have supported a different finding by the District Court is a question not here presented. *Commissioner v. Tower,* 327 U. S. 280, 292.

In the *Culbertson* case, the Supreme Court stressed (pp. 740, 748) the importance of participation in the business by the partners during the tax years through the performance of services or because of contributions of capital of which they were the "true owners." In this regard, failure of the alleged new partners to perform "vital services," or to contribute "original capital," or to participate in "management and control of the business" has the effect of placing "a heavy burden on the taxpayer to show the

bona fide intent of the parties to join together as partners." *Commissioner v. Culbertson, supra,* p. 744. None of these criteria is satisfied in these cases.

1. No Vital Services.

The District Court found that neither the children nor Flo Parker contributed any services to the partnership at any time. [R. 49, 51.] The wife admitted that during 1942 and 1943, prior to the alleged partnership with the children, she was not active in the business, did no work and drew no salary. [R. 92.] The record discloses no different situation after the alleged new partnership was formed, and that is also true with respect to the children. At the time the alleged partnership agreement became effective (November 1, 1943), taxpayers' two sons were aged three and six, and the daughters were eleven and fourteen years of age. [R. 73.] At the time of the trial of this case (May, 1956) [R. 48], the younger son was aged fifteen and a high school sophomore; the older son was aged ninteen and a college freshman. Even in the more recent years not here involved, other than during summer vacations and various odd occasions, neither worked in the business. [R. 67-68, 88-91.] There is no evidence that taxpayers ever expected their daughters to enter the business. [R. 66.] Although both taxpayers testified that their purpose in making the gifts to their children was, in part, to interest them in entering and carrying on the business, neither son was certain that he would enter the business. [R. 61, 89, 90, 93.] It is clear, therefore, that there was no intent that through the performance of services the children would enter into the "present conduct" of the business, and, as stated in *Culbertson* (p. 740): "The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income."

2. No Contribution of Capital of Which the Children Were the True Owners.

The District Court found that capital was not a material income-producing factor of the Southern Heater Company during the years involved. [R. 54.] Taxpayers contend otherwise. (Br. 12.) However, it is not contradicted, as the court below found, that "Starting with little capital" taxpayer Elgin R. Parker had increased the income of the company from $30,000 at the date of its inception in the late nineteen thirties until October 31, 1943, so that for that fiscal year the company showed a net profit of $193,000. [R. 49, 71.] This constituted the approximate amount of the beginning capital of the alleged new partnership. [R. 165.] Thereafter, all the capital used in the operation of the business came from the operations and profits of the company, and, as Mr. Parker admitted and the court below found, he operated the business in the same manner after November 1, 1943, as he previously had. [R. 52, 62, 79.] Since, with "little capital" as a beginning, the income from the business increased steadily from 1938 to October, 1943, and further increased during the war years, 1943-1946, and inasmuch as Parker continued to run the business in the same manner after the formation of the alleged new partnership, it would seem to follow, as the court below found, that capital was not a *material* income-producing factor, but rather that the income was produced "entirely as the result of the personal services of Elgin R. Parker and of the capital which the Southern Heater Company had at the commencement of the partnership and which was additionally accumulated from retained earnings." [R. 53-54.] Of course, the mere fact that it was necessary to have "cash" with which to operate [R. 69], does not mean

that capital was a material income-producing factor in the business.

In support of their contention that capital was a material income-producing factor, taxpayers point (Br. 22) to Parker's salary of $12,000 a year which was received from November, 1943, to May, 1946, when the partnership's manufacturing assets were transferred to two corportations in exchange for their stock. [R. 64, 69.] It is noted, however, that in connection with their claims against the children's estates, it was stated that "The father received a salary of but $12,000, whereas his services were worth at least $52,000 per year." [R. 54, 80.] This additional factor lends support to the finding of the District Court, whose function it was to weigh the evidence, draw inferences, and disclose the result,[5] that capital was not a material income-producing factor.

Even if it be assumed that taxpayers are correct in their contention that capital was a material income-producing factor, nevertheless the children were not the true owners of any business capital such as to warrant taxation of any income earned thereby to them. The position of the Internal Revenue Service for taxable years beginning prior to January 1, 1951, with respect to family partnerships in which capital is a material income-producing factor, is contained in Mim. 6767, 1951-1 Cum. Bull. 111. The aspects of the family partnership problem there discussed and here considered have to do with the question of whether an alleged partner is the real owner of an interest in capital of a partnership which is attributed to him.

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[5] *Helvering v. Kehoe,* 309 U. S. 277, 279.

(a) Reality of Capital Contribution.

It is stated in the Service's mimeograph that (p. 113):

> In the ordinary gift capital case, the question whether a donee's partnership interest represents a mere "surface change of ownership," or conversely whether the donee has exercised dominion and control over his or her interest, represents the heart of the issue whether a partnership in good faith was intended, at least in those cases where the donee has not performed substantial services. In turn, all of the elements of the test of good faith intent laid down in the *Culbertson* opinion have an immediate bearing upon the reality of the donee's ownership * * *.

One of the elements having an immediate bearing on the reality of the donee's ownership is his capital contribution. In this regard the presence or absence of "original" capital remains one of the factors to be considered, although, as the mimeograph states (p. 112), "the absence of 'original' capital creates, rather than answers, the problem whether an alleged partner is entitled to recognition." That element of the test, as enunciated in *Commissioner v. Tower,* 327 U. S. 280, and *Lusthaus v. Commissioner,* 327 U. S. 293, and reiterated in *Culbertson,* has not been changed, insofar as concerns the tax years here involved, by the amendment of the law with respect to family partnerships effected by Section 340(a) and (b) of the Revenue Act of 1951, c. 521, 65 Stat. 452. Section 340(a) of that Act amends Section 3797 of the 1939 Code to provide that a person shall be recognized as a partner for income tax purposes "if he owns" a capital interest in a partnership in which capital is a material income-producting factor "whether or not such interest

was derived by purchase or gift from any other person." However, Section 340(c) of that Act provides that such amendment is applicable only to taxable years beginning after December 31, 1950, and that determination as to whether a person shall be recognized as a partner for income tax purposes for taxable years before January 1, 1951, "shall be made as if this section had not been enacted and *without inferences drawn from the fact that this section is not expressly made applicable with respect to taxable years beginning before January 1, 1951.*" (Italics supplied.) It is clear then that for tax years beginning prior to January 1, 1951, "original" capital remains a factor to be considered in determining the *bona fides* of the true ownership of a partnership interest. For subsequent years, the amendment effected by Section 340 (a) merely makes it clear that regardless of how "the real owner" of a partnership acquired his interest, or what motivated the transfer to him, or whether the business benefited from the entrance of the new partner, the income is taxable to such owner. H. Rep. No. 586, 82d Cong., 1st Sess., p. 32 (1951-2 Cum. Bull. 357, 380); S. Rep. No. 781, 82d Cong., 1st Sess., p. 38 (1951-2 Cum. Bull. 458, 485.

In the instant case, we note, therefore, as pointing to the fact that the children were not the true owners of a capital interest in the partnership, that they did not contribute any original capital. Rather their alleged capital interests arose by way of gifts of an interest in a partnership then being conducted by their parents. [R. 49.] In a memorandum filed with the Superior Court in 1946 in conjunction with taxpayers' application for compromise of the 1944 tax claims, it was claimed that "The parents furnished all the capital." [R. 83-85.] The mere fact

that those deeds of gift may have been legally sufficient and irrevocable is not determinative for "Reality and good faith are not ascertainable by any mechanical or formalistic test." Mim. 6767, *supra,* p. 113; *Commissioner v. Culbertson, supra,* p. 745; *Feldman v. Commissioner,* 186 F. 2d 87, 91 (C. A. 4th).

Furthermore, to say as taxpayers do (Br. 23) that the children "made original contributions of their retained earnings" assumes that they were the "true owners" of part of the capital contributed to the business and thus begs the question to be decided. Unless it can be said that "considering all the facts" the children really owned the gift capital, they had no retained earnings or profits to reinvest in the business. At most it can only be said that "the retention of partnership earnings with the acquiescence of the donee for the reasonable needs of the business is not inconsistent with *bona fide* ownership by the donee." Mim. 6767, *supra,* p. 115. It does not establish ownership, even assuming that in this case the retention was "with the acquiescence" of the donees, since the two sons, at least, did not even know about the gifts until after the alleged partnership was dissolved. [R. 89, 91.]

(1) *No Participation in Management and Control.*

As pointed out above, the District Court found that the children did not participate in the management and control of the business. [R. 51.] In an attempt to answer this finding, the taxpayers state (Br. 29) that "under the law the control of the business changed from the appellants to the Superior Court, and thus to the children." However, as the District Court pointed out in its findings [R. 51], although taxpayer Elgin R. Parker, as

guardian of the children's estates, filed annual reports with the Superior Court, permission of the Superior Court was neither sought nor obtained for the operation of the business, and at no time was any act of Parker, as guardian, opposed by any party, nor was any petition or request by him to the Superior Court denied. These facts are not denied by taxpayers nor controverted by any facts of record, but rather are supported thereby. [R. 146-147, 149, 150.] As a matter of fact, taxpayer Elgin R. Parker admitted that after the partnership arrangement was accepted by the probate court he continued to run the business as before. [R. 62, 79.] Specifically, he testified that at the time the gifts were made in October, 1943, he was acting as "president and general manager of the entire operation of the business, and after making the gifts my duties were the same"; that although he discussed "vital" matters with his wife and sought instruction from the court on a number of matters, he "did not obtain authorizations from the court for decisions in the regular operation of the business." [R. 79.] Mrs. Parker also testified that she was not active in the business and did not participate in any of the management decisions or other decisions with regard to the operation of the business; and that although Mr. Parker discussed things with her, "he made the decisions." [R. 92.] The guardianship proceeding, then, had no effect whatsoever on Parker's control and operation of the business. It is clear, therefore, that taxpayer Elgin R. Parker exercised sole control in the operation of the Southern Heater Company and subsidiary corporations, as the court below found. [R. 51.]

(2) *Income Distributions and Right to Withdraw.*

Unless Parker instituted the proceedings, the children could neither withdraw from the partnership nor receive actual distributions of income from the business. In fact, except for a disbursement of $3,750 in United States war bonds to each of the four children, they received no distributions from the earnings and profits of the business during the period of its operation. [R. 51.] On the other hand, taxpayers had borrowed some $214,000 from the partnership for which they gave notes. [R. 80.] As far as the record shows, those notes were unsecured. As stated in the *Culbertson* opinion, *supra,* p. 747, "Whether he [a donee] is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the business." Such was not the fact in the case of the children involved herein. Rather, Parker, as general manager and guardian, retained the powers of management and full discretion as to the time and amounts of distributions of profits, and he therefore, together with his wife, remained the substantial owner of the interests purportedly given away. *Toor v. Westover,* 200 F. 2d 713, 717 (C. A. 9th).

3. Motive and Business Purpose.

Referring to the test of intent stated in the *Culbertson* opinion, *supra,* the Internal Revenue Service considers that the test of "business purpose" may be satisfied by the single fact (if it be a fact) that the alleged partner has invested in the business money or property, useful to the business, of which he or she is the "real owner" under principles discussed above, even though such money or property had already been used in the business before the alleged partner acquired any interest therein. Mim. 6767, *supra,* p. 117. As we have demonstrated, and as

the District Court concluded [R. 55-56], taxpayers have failed to establish that the children were true owners of any partnership interest under those principles—hence the test of "business purpose" is not satisfied.

The avowed reason given for the making of the gifts to the children was to give them some assets or security which would protect them "in case of any bad business decision of my own or bad business in general," or in the event of the death of the taxpayers, and to induce them to enter the business. [R. 60, 61, 93.] The facts of the case, however, indicate otherwise. As the court below pointed out [R. 52], this expressed purpose is not credible and lacks foundation when considered in light of the fact that taxpayers created a general partnership which rendered the entire interest of the children subject to the claims of creditors. Parker was aware of this fact. [R. 72, 73-74.] On the other hand, from a tax point of view, the creation of a corporation was not as desirable as the formation of a partnership. During the war years, through 1945, there was in existence a corporate excess profits tax, imposed at the rate of 85½ per cent. It may be argued that taxpayers were cognizant of this in view of the fact that in 1946, after the repeal of that tax, they transferred the operating assets of the business to two corporations.

Neither does the stated purpose of inducing the children to enter the business have any merit as a business purpose, as is indicated above. Rather it is a *personal* purpose. *Hash v. Commissioner,* 152 F. 2d 722 (C. A. 4th), certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879. In a similar situation, this Court refused to sanction an "obvious device" whereby a wife and children were given "ostensible interests for no apparant purpose

except to build up an estate in the children at the expense of the United States." *Smith v. Westover,* 237 F. 2d 201, 203. The same reasoning and result should obtain herein.

Lack of business purpose is also demonstrated by the presence here of a tax avoidance motive—"one of many factors to be weighed in the determination of the reality of an intrafamily gift * * * and of the existence of *bona fide* partnership intent." Mim. 6767, *supra,* p. 117. As said in *Commissioner v. Tower, supra,* p. 289, a showing that the arrangement was made for the express purpose of reducing taxes "simply lends further support to the inference" that the claimed partnership is unreal. Mr. Parker testified that he was aware that, if there was any profit, there would be a tax advantage in making the gifts [R. 61] and that he and his wife expected when the gifts were made that the children would pay the tax on their share of the income. [R. 70, 141.] Although he also testified that he would have made the gifts regardless of any tax advantages [R. 61, 75, 86], such self-serving testimony is contradicted by other testimony and documentary evidence to the effect that if taxpayers had to pay taxes on all the partnership income "in about three and a half years, starting with 1944, we would have had no interest left in the business and the children would have owned it all". [R. 70, 140.]

The presence of this tax avoidance motive in making the gifts is also evidenced by the applications filed by taxpayer Elgin R. Parker as guardian of his children's estates wherein he sought permission of the probate court to apply refunds due the children as well as additional sums of money from the capital accounts of the guardianship estates in payment of the tax deficiencies asserted

against him and his wife. [R. 138-146.] In the absence of any objection to these requests, the permission was granted. The orders of the probate court provided that in the event taxpayers lost their litigation with respect to the incidence of the tax on the income of the partnership, they were to keep and retain the refunds in at least part settlement of their claims against the guardianship estate on account of income taxes, and that if they were successful, they were to pay the refunds to the guardianship estates plus any interest benefits they might have obtained. [R. 146-151.] The second of these orders, dated July 30, 1948, further provided that if the parents eventually lost their income tax litigation, they could keep the refunds payable to the children and have permission to apply for further allowances. [R. 151, 157.] Pursuant to that provision, an order of the probate court was subsequently obtained permitting distribution of an "additional income tax burden" of $223,-913.92 (after giving effect to the refunds given to the four children for the period November 1, 1943, to the dissolution of the alleged partnership on October 31, 1948) "on the family in accordance with the distribution of the partnership income." [R. 103-104, 156-159.] Subsequent reports and decrees in the guardianship proceedings showed the retention of money or assets as a reserve against the claims filed by taxpayers on account of the income tax deficiencies asserted against them. [R. 104-116.] Such proceedings show that at the time of the gifts and the creation of the alleged new partnership, "it was expected and anticipated that each of the partners, including the four minors, would be taxable on their shares of the partnership income" [R. 76, 139, 141], and that, failing realization of such purpose, it was not

intended that the children share in the partnership income as true owners of a capital interest in the partnership. This is made doubly clear by taxpayers' assertion that the incidence and result of the federal income tax liability, if the children paid no tax at all, was "insufferable and unintended," that the incidence and result if all shared in the tax burden in proportion to their partnership interests was "unsatisfactory" since to pay the federal and state taxes would take approximately all their earnings "while the four children grew rich" [R. 177-178], and that only the result achieved by the children paying all the additional tax was "most equitable". [R. 179.] At another point in his testimony, Parker acknowledged that if it had been "spelled out" at the time the gifts were made he (and his wife) would have had to pay the tax on the income he would have "immediately liquidated" and there would not have been any business to tax. [R. 75-76.] Obviously, then, there was no real intrafamily gift and no *bona fide* intent to form a business partnership. Rather, it appears from the facts of record that taxpayers' sole purpose in making the gifts and entering into the alleged partnership arrangement with their children was to obtain a tax benefit at the expense of the United States, without even an incidental business purpose. Certainly the taxpayers herein would not have entered into such an arrangement with strangers.

Conclusion.

The judgment of the District Court is correct and should be affirmed.

Respectfully submitted,

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May, 1957.

APPENDIX.

Internal Revenue Code of 1939:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *.

(26 U. S. C. 1952 ed., Sec. 11.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal services of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U. S. C. 1952 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(26 U. S. C. 1952 ed., Sec. 182.)

Sec. 3797. Definitions.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

*   *   *   *   *   *   *   *

(2) *Partnership and partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

*   *   *   *   *   *   *   *

(26 U. S. C. 1952 ed., Sec. 3797.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(a)-1. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, * * *.

*   *   *   *   *   *   *   *